Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:RFPH:JAX:NA:POSTF-142796-02
VCBrooks, ID# 62-11213

date: November 1,2002

to: [redacted], LMSB, Team Manager, Group [redacted]
Internal Revenue Service, [redacted]

from: Associate Area Counsel, LMSB:Area 3:RFPH-Nashville

subject: [redacted], Inc. & Subsidiaries
[redacted]
EIN: [redacted]

This is in further reply to the request from Revenue Agent [redacted] for our opinion on the issues set forth below and will confirm the advice conveyed to Revenue Agent [redacted] in telephone calls by the undersigned.

ISSUES

1. Where the family farm corporations filing a consolidated income tax return consisted of a parent and three subsidiaries for the period in [redacted] when the suspense account of the family farms in the amount of $[redacted], was established pursuant to I.R.C. § 447(i), what method should be used to determine the portion of the suspense account to be included in income pursuant to I.R.C. § 447(i)(5)(B) for the year [redacted], where the consolidated group filing the return consisted of the parent and [redacted] subsidiaries.

2. If it is not possible to allocate the original suspense account to the numerous subsidiaries filing the consolidated income tax return for the periods involved ([redacted], [redacted], and [redacted]), is it permissible to determine the taxable income of the group for purposes of the 50% test under section 447(i)(5)(B)(i)(II), by combining the taxable income of the farm companies and eliminating therefrom the intercompany expenses?

3. Or, since the parent is the only surviving company of the four original corporations filing the consolidated return for the period in which the suspense account was established, is it correct to look only to the taxable income of the parent for purposes of the 50% test.

CONCLUSIONS

The above issues were raised by Revenue Agent [redacted] in response to our opinion of July 31, 2002, wherein we concluded that in determining the portion of a suspense account of a family farm which must be included in income pursuant to section 447 (i)(5)(B) the Service position is that gross receipts are determined on a separate corporation basis for family corporations filing a consolidated income tax return. In such opinion, we further concluded that based on the few facts available there seemed a possibility that the parent-taxpayer has transferred assets of businesses among the numerous subsidiaries subsequent to the establishment of the suspense account and we therefore suggested that you attempt to ascertain whether the taxpayer has correctly reported the gross receipts (and matched up the suspense account) of each of the separate family corporations filing the consolidated income tax returns for the periods involved.

Inasmuch as our opinion of July 31, 2002, was essentially the same as that reached in PLR 9428004 which may not be used as a precedent and in the absence of any other specific ruling on the question, we forwarded our opinion to the National Office for post review. The National Office via email of August 20, 2002, (CC:IT&A:3) stated that it agrees with our general rule which would apply in the situation where there has been no material change in the structure of a consolidated group. However, in view of what may have been material changes in the corporate structure here since the change of accounting methods and establishment of the suspense account required by section 447,the National Office stated that the case would appear to present a complicated situation that should be addressed in the context of a request for technical advice in order to obtain a specific clear answer.

Because the issue appears to be one of first impression not only for the three years involved in the present cycle but most likely for the succeeding [redacted] years, we agree that the issues warrant a request for technical advice following the provisions of Rev. Proc. 2002-2, 2002-1 I.R.B. 82. Accordingly, our discussion below is to make some preliminary suggestions on what facts to develop with the taxpayer's agreement which should accompany the request for technical advice from the National Office.

FACTS AND ANALYSIS

A detailed statement of the facts and history of section 447 is set forth in our Advisory Opinion in this case referred to above dated July 31, 2002, wherein we concluded that the gross

receipts (and net operating losses) for purposes of section 447 (i)(5)(B) are to be determined on a separate corporation basis for family corporations filing a consolidated income tax return. Accordingly, we will discuss herein only the additional facts supplied by Revenue Agent [redacted] and that portion of section 447 which we think is pertinent to resolving the issues set forth above.

In the year ([redacted]) of the change to the accrual method of accounting and the establishment of the suspense account of $[redacted] required by section 447, the taxpayer-parent ([redacted]) filed a consolidated return with its three wholly owned subsidiaries: [redacted], [redacted] and [redacted]. In this first year ([redacted]), income was reported for the group by each of the corporations with the majority of the total income reported by [redacted]. During the period beginning with the tax year [redacted] through the tax year [redacted], [redacted] acquired over [redacted] different companies some of which were retained and many of which were sold. Throughout this period [redacted] reorganized the consolidated group by transferring business activities within the control group with a large portion of the farm income being reported by [redacted] different subsidiaries during the years under examination.

The only company to survive the group filing the return for the tax year [redacted] when the suspense account at issue was created is [redacted]. Thus, for the tax year ending [redacted] (the first year subject to the amendment to the statute which required the family farm corporation to include a portion of the suspense account in income over a period of 20 years), the taxpayer separated each of the corporation's taxable income and reported the amount from the suspense account based only on the income of [redacted].

Under the statute applicable here after the amendment in 1997, the amount to be included in each year's gross income under section 447 (i)(5) is equal to the lesser of: (1) the amount that would ratably reduce the remaining amount in the suspense account to zero over the first 20 taxable years; or (2) 50% of the corporation's taxable income for the year, or if the corporation has no taxable income for the year, the amount of its net operating loss for the taxable year. For purposes of the 50% taxable income limitation, the taxpayer, looking only to the taxable income of [redacted], did not include any income from the suspense account in the taxable year [redacted]. The taxpayer included $[redacted] from the suspense account in income in the taxable year [redacted] and $[redacted] from the account in income in taxable year [redacted].

Revenue Agent [redacted] is of the opinion that in order to apply

the income recognition provision of section 447(i), it is necessary to compare the businesses of the control group when the suspense account was created in [redacted] with the current structure and businesses of the group. He points out that in the year ending [redacted] there were 4 companies included on the consolidated return: [redacted], all which were in the [redacted] business. Over the next [redacted] years until the current cycle, [redacted] expanded its operations by transferring some of the activities between the existing companies and creating new companies to diversify its operations.

Because there has been substantial transfer of activities between [redacted] and the current members of the consolidated group for the years involved, Revenue Agent [redacted] believes that the amount of taxable income that should be used in the computation of the amount of the suspense account to be included in income should be comprised of the taxable income of the [redacted] companies less their intercompany expenses. The main intercompany account that would be eliminated would be amounts paid to [redacted] which was formed in [redacted] to reflect the income earned from royalties by [redacted]. Based on this formula, the [redacted] companies would have sufficient taxable income to report additional amounts of the suspense account as required under section 447 (i) in the three years under examination. The adjustment based on such computation would be a $[redacted] increase in [redacted] and an increase of $[redacted] in [redacted]. There would not be any increase over the amount reported by the taxpayer for [redacted], i.e., $[redacted].

The taxpayer does not agree with the additional amounts determined by Revenue Agent [redacted] on the ground that the requirement to include the portion of the suspense account in income equal to 50% of the corporation's taxable income for the year applies to [redacted] only; and does not include other companies that have been reorganized or purchased since the suspense account was established in [redacted].

The taxpayer also maintains in its response to Revenue Agent [redacted]'s proposed adjustment that since the 50% taxable income limitation also applies to the [redacted] tax period when [redacted] had a loss, it erroneously included $[redacted] in income for this tax period which should now be corrected. However, we understand from Revenue Agent [redacted] that the taxpayer has subsequently dropped this demand and now maintains that the tax returns of [redacted] were properly filed for all three years with respect to the amount to be included into income from the suspense account.

The proper solution to the question as to what should be

included into income from the suspense account would seem to be one based on a determination as to what businesses created the suspense account due to the change in the method of accounting in [redacted]. Having established the businesses from which the account was created, the next step would be to attempt to trace the businesses and the accounts until the first year at issue here to determine what portion of such accounts should be reported by which corporation owning the business during the year of examination. Another approach would be to determine which of the original businesses still remained in existence which are being operated by [redacted]. Presumably, between these two approaches the parties should be able to determine which of the original businesses is still being operated to which the original suspense account should be allocated.

In the event the suspense account should be allocated to any of the three subsidiaries which were part of the group in the consolidated return for which the suspense account was first established, there is the possibility that if any of these corporations lost its family farm status that their portion of such suspense account should be included in income under section 447(i)(3). See PLR 9428004 discussed in our opinion of July 31, 2002.

In the final analysis, we agree with Revenue Agent [redacted] that the taxpayer should not be allowed to spinoff its [redacted] activities to new corporations and still maintain that the amount in the suspense account attributable to such businesses should not be considered when computing the taxable income for purpose of applying the 50% limitation set forth in section 447(i)(5)(B)(i)(II). However, the taxpayer is correct in its statement that the Internal Revenue Code does not define taxable income of a corporation for purposes of the 50% taxable income limitation test and the Service has not issued any regulations to make such determination. Therefore, the question should be resolved by the National Office,if possible.

Nevertheless, we believe an effort to determine the businesses which created the amounts which make up the suspense account and the present status of such businesses would aid the National Office in resolving this issue of first impression. We therefore recommend that you make every effort to reach an agreement with the taxpayer on the attribution and allocation of the suspense account at issue and the [redacted] income which should be considered in determining what portion of the suspense account should be the basis for determining the amount that should be reported as income under section 447(i)(5), as amended by the Taxpayer Relief Act of 1997.

We, of course, will be happy to assist you further in this matter regarding any questions that may arise during your analysis of the attribution and allocation of the suspense account and the current [redacted] income among the related corporations. As requested by Revenue Agent [redacted] we are forwarding to him (via fax) a copy of a request for technical advice in a case reviewed by this office within the past few months as an example to be used in preparing the request for technical advice. We will be happy to discuss and review his proposed request at any time during its preparation.

This writing contains privileged information. Any unauthorized disclosure of this writing will have an adverse effect on privileges, including the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

The conclusion reached herein has been discussed with Rogelio Villageliu, Industry Counsel for Agriculture, who has indicated that he agrees with the conclusion and our suggestions regarding the development of additional facts.

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Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:RFPH:JAX:NA:POSTF-116944-02
VCBrooks, ID# 58-08809

date: July 31,2002

to: [redacted], LMSB, Team Manager, Group [redacted]
Internal Revenue Service, [redacted]

from: Associate Area Counsel, LMSB:Area 3:RFPH-Nashville

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subject: [redacted], **Inc. & Subsidiaries**
[redacted]

EIN: [redacted]

This is in reply to the request from Revenue Agent [redacted] for our opinion on the issue set forth below and will confirm the advice conveyed to Revenue Agent [redacted] in telephone calls by the undersigned.

ISSUE

For purposes of I.R.C. § 447(i)(5)(B), pertaining to the determination of the portion of a suspense account of a family farm which must be included in income, are gross receipts determined on an aggregate or separate corporation basis for family corporations filing a consolidated income tax return?

CONCLUSION

Despite the gross receipts test for family corporations set forth in I.R.C. § 447(d), for purposes of I.R.C. § 447(i)(5)(B), the Service position is that gross receipts (and net operating losses) are determined on a separate corporation basis for family corporations filing a consolidated income tax return.

Based on the few facts presented at this stage of the examination, there is a possibility that the parent taxpayer has transferred assets or business among the numerous subsidiaries in an effort to manipulate the income inclusion requirement of I.R.C. § 447(i)(5)(B) by each of the separate corporations. We therefore suggest that your examination consider this possibility and attempt to ascertain whether the taxpayer has correctly reported the gross receipts (and matched up the suspense account)

of each of the separate family corporations filing the consolidated income tax return.

FACTS AND ANALYSIS

[redacted]

[redacted][1]

According to his memorandum, Revenue Agent [redacted] is the Team Coordinator for the Exam Team auditing the taxpayer group's consolidated federal income tax returns filed for the years [redacted], [redacted] and [redacted]. The taxpayer group for the years involved filed their consolidated income tax returns using the accrual method of accounting which they had been doing since [redacted]. For years prior to [redacted], however, the taxpayer group employed the cash receipts and disbursement method of accounting.

On [redacted], they were required to adopt the accrual method of accounting pursuant to the amendment to section 447 of the Internal Revenue Code which extended mandatory use of the accrual method of accounting to "family" corporations with annual gross receipts exceeding $25 million. In connection with this mandatory change, section 447(i) of the Code required the taxpayer group to establish a suspense account, in lieu of taking into account adjustments under Section 481(a), due to the change in the method of accounting. As a result, in the year of the change to the accrual method the taxpayer established a suspense account in excess of $[redacted].

Section 447(a) of the Internal Revenue Code provides that [redacted] corporations in general are required to use an accrual method of accounting unless the farm corporation has gross

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[1]The preceding description of the taxpayer's operations is a condensed version of its operations stated in its annual report for the fiscal year [redacted].

receipts of less than $1 million or is a family corporation with gross receipts of less than $25 million.

The Committee Report with respect to the bill that added Section 447 to the Code stated that for purposes of the provision, [redacted] is intended to be defined broadly to include the cultivation of land, the raising and harvesting of any agricultural or horticultural commodity and the raising, shearing, feeding, caring for, training and management of animals (including fish, bees, livestock and poultry). See Committee Reports on PL 94-455 (Tax Reform Act of 1976) Sec. 207, 1976-3 C.B. 53 and 787. For purposes of this opinion, we have assumed that the parent and each of its subsidiaries involved here are in the [redacted] business although there appears to be a possibility that a few of the subsidiaries may not be engaged in such business.

We have also assumed that the parent and its numerous subsidiaries constitute a family corporation within the meaning of I.R.C. § 447(d)(2)(C) which defines a family corporation as (i) any corporation if at least 50% of the total combined voting power of all classes of stock entitled to vote, and at least 50% of all classes of stock of the corporation are owned by members of the same family, and (ii) any corporation described in section 447(h) pertaining to certain closely held corporations. According to Revenue Agent [redacted] the taxpayer does meet the requirements of this section since the [redacted] family owns about [redacted]% of all classes of stock in the taxpayer.

In determining whether a family corporation has annual gross receipts in excess of $25 million for the prior year, beginning after December 31, 1985, section 447(d) provides that all corporations which are members of the same controlled group of corporations (within the meaning I.R.C. § 1563(a)) shall be treated as one corporation. (The taxpayer was required to use the accrual method of accounting from the date of the amendment to section 447 requiring such use, according to Revenue Agent [redacted].)

Section 447(f) provides, in part, that in the case of any taxpayer required by this section to change its method of accounting for any taxable year, the net amount of adjustments required by Section 481(a) to be taken into account by the taxpayer in computing taxable income shall be taken into account in each of the ten taxable years beginning with the year of the change.

Section 447(i)(1) of the Code provides generally that if any family corporation is required by this section to change its

method of accounting for any tax year (the year of the change) such corporation shall establish a suspense account in lieu of taking into account adjustments under § 481(a) with respect to amounts included in the suspense account. Prior to the Taxpayer Relief Act of 1997, a family corporation usually was not required to take the entire section 481 adjustment into income under the ten year recognition period prescribed by § 447(f). Under some circumstances suspense accounts were available wherein family corporations could indefinitely defer the § 481 adjustment, pending the termination of the family corporation or the happening of certain other events. However, for tax years ending after June 8, 1997, the statute was amended to require the family farm corporation to include a portion of the suspense account in income over a period of 20 years. The amount to be included in each year's gross income is equal to the lesser of: (1) the amount that would ratably reduce the remaining amount in the suspense account to zero over the first 20 taxable years; or (2) 50% of the corporation's taxable income for the year, or if the corporation has no taxable income for the year, the amount of its net operating loss for the taxable year. § 447(i)(5), as amended by the Taxpayer Relief Act of 1997, P.L. 105-34, Sec. 1081, 1997-4, Vol. 1, C. B. 163.

According to Revenue Agent [redacted] the taxpayer "split up the controlled group" in determining the amount to be included in income under the formula described above and did not include any income from the suspense account in taxable year [redacted]. The taxpayer did include $[redacted] from the suspense account in income in taxable year [redacted] and $[redacted] from the account in income in taxable year [redacted]. He states that the "main corporation" had in [redacted] negative taxable income; in [redacted], enough taxable income to require the inclusion of 1/20th of the suspense account balance into income; and in [redacted] taxable income of $[redacted] so as to limit the inclusion (apparently to 50% of the corporation's taxable income for the year).

In making determinations as to what should be included into income from the suspense accounts, the taxpayer apparently has determined gross receipts on a separate corporation basis rather than on an aggregate basis for the consolidated group. [redacted] states that he has not been able to find any authority for this position except PLR 9428004 (April 7, 1994) 1994 PRL LEXIS 680, wherein the Service concluded that for purposes of § 447(i)(3)[since deleted by the 1997 Act and replaced by § 447(i)(5)as noted above] gross receipts are determined on a separate corporation basis for family corporations filing a consolidated income tax return. Revenue Agent [redacted] states that he has trouble accepting the conclusion of the ruling inasmuch as § 447(d) requires the taxpayer to combine all members of the

controlled group for purposes of the gross receipts test. So, he asks: why would the Service now separate them for the limitation on the inclusion of a portion of the suspense account required by § 447(i)(5)(B)?

While the private letter ruling (PLR) referred to by Revenue Agent [redacted] cannot be used or cited as a precedent under I.R.C. § 6110(j)(3), by either the taxpayer or the Service in this case, we believe the rationale of the ruling is sound and should be accepted as the proper interpretation of what was § 447(i)(3)and now is essentially § 447 (i)(5)(B)in that both sections provided the criteria for reducing and including the suspense account into income. The PLR first dealt with the taxpayer's argument (the same as [redacted]) that § 447(i)(3) should be interpreted consistently with § 447(d) which contains a gross receipts test under which family corporations whose gross receipts exceed a threshold of $25 million are required to use the accrual method of accounting. As mentioned above, § 447(d)(1) expressly provides that for purposes of this gross receipts test "all corporations which are members of the same controlled group of corporations shall be treated as one corporation." The taxpayer argued, according to the ruling, that if the gross receipts of the related corporations must be taken into account in determining when a corporation is large enough to justify the elimination of the benefits of the cash method, it is only logical that Congress intended the gross receipts of those related corporations to be taken into account in determining the extent to which the cumulative benefits of the use of the cash method are retained through the suspense account or when they are required to be recaptured.

After tracing the legislative history of section 447, the ruling points out that section 447(i)(5)[redesignated by the 1997 Act as § 447(i)(3)] of the Code clearly provides that if a corporation ceases to be a family corporation the amount in its suspense account shall be taken into income, which determination could only be made on a separate corporation basis. The ruling notes that a corporation losing its family farm status must include the amount in its suspense account in income regardless of whether any or all of the other members within its control group retain their status as family corporations. Similarly, opines the ruling, the income inclusion of section 447(i)(3)[section deleted by the 1997 Act but similar in effect to current § 447 (i)(5)(B)as noted above] should be applied on a separate corporation basis.

The ruling points out in distinguishing the two sections involved that the then § 447(i)(3) is concerned only with gross receipts from [redacted], whereas § 447(d) contains no such

limitations in its gross receipts test under which family corporations whose gross receipts exceed $25 million are required to use the accrual method of accounting. The more logical approach according to the ruling was to apply Section 447(i)(3) consistent with § 447(i)(5) to carry out the Congressional intent so that both provisions setting forth the circumstances in which a suspense account must be included in income are in concert; i.e., on a separate corporation basis.

The ruling goes on to refute two other arguments made by the taxpayer involved in support of determining that the family gross receipts should be made on a consolidated basis when a consolidated return is filed. The refutations are based essentially on the same rationale discussed above; i.e., that the term "taxpayer" when used to determine the amount of the suspense account to be included in income refers to a corporation that is a member of the consolidated group rather than the group as a whole.

Similarly, we believe that the current sections 447(i)(5) and 447(i)(3) must be applied consistently to carry out the Congressional intent as to when a suspense account should be included into income; i.e., on a separate corporation basis.

In view of the fact that the PLR cannot be used or cited as a precedent, and the possibility that the instant case may be distinguishable from the factual pattern discussed in the PLR, we obtained the closed legal file in [redacted]. Our review of the file in such case and the Action Memorandum of the Appeals Office which settled the case led us to conclude that there were no facts to distinguish the instant case from the factual pattern discussed in the PLR and we so advised Revenue Agent [redacted] by telephone of such conclusion. At his request we faxed him the pertinent documents from the legal file including the Action Memorandum of the Appeals Office for his review.

In our discussion with Revenue Agent [redacted] we suggested the possibility that the "main corporation" may have reported negative taxable income in [redacted] due to some improper allocation of income among the related corporations. In other words, there seems to be a possibility that the group may have manipulated the farm income between the numerous corporations to limit the portion of the suspense account balance of each corporation to be included in income. We, of course, will be happy to assist you further in this matter regarding any questions that may arise during your analysis of the attribution and allocation of [redacted] income among the related corporations.

This writing contains privileged information. Any unauthorized disclosure of this writing will have an adverse effect on privileges, including the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

The conclusion reached herein was discussed with Rogelio Villageliu, Industry Counsel for Agriculture, who has indicated that he agrees with the conclusion. However, since our conclusion is essentially the same as that reached in PLR 9428004, which may not be used as a precedent, and in the absence of any other specific rulings on the question, we are forwarding our opinion to the National Office for post review. We hope to advise you of the National Office's reply within 20 days.

In the meantime, if you have any questions, do not hesitate to seek our further assistance at any time at (615) 250-5509.

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